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# *Concerning Trust Receipts*

*by*

KARL T. FREDERICK

AMERICAN ACCEPTANCE COUNCIL
120 Broadway New York

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# *Concerning Trust Receipts*

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*by*

KARL T. FREDERICK

AMERICAN ACCEPTANCE COUNCIL

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# Concerning Trust Receipts

The trust receipt is a small corner of the law. It is, frankly, one of the most difficult little corners that I have ever happened upon. There have been many cases in which trust receipts have been the subject of litigation but, unfortunately, there is comparatively little light to be found in the bulk of judicial opinion on the subject.

Trust receipts are a decidedly new type of security —I mean when you compare them with other types of security. They are only about fifty-five or sixty years old, and I should say the first forty-five years of their use was a period when neither lawyers nor bankers knew what they were using nor why they were upheld by the courts.

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From a legal standpoint one may begin to examine the origin of trust receipts perhaps thirty years before they were definitely used. That was what you might call a preparatory period. They were an evolution and, as I say, until the last few years very few bankers, lawyers or judges, have had any logical idea of what a trust receipt was or where it could be used or what principles of law underlay it. Consequently, if the subject has been a puzzling one in any way to any of you you needn't feel any surprise because it really is, at least from a lawyer's stand-

point, and, so far as I have seen in practice from a banker's standpoint, a difficult proposition to understand.

The trust receipt as a form of security here in the East at least and in some other parts of the country, is now well recognized. Certainly in Massachusetts, Connecticut, New York, Pennsylvania, New Jersey, Maryland, Delaware, Louisiana, Wisconsin, and some other states, it is well known and in common use. It is also used to some extent abroad.

Security in general may be classified under two types—a type which depends upon possession for its validity and a type which depends upon title, quite apart from possession, for its validity. Under the first head, as you know, you have the common type called pledge, where property is placed in the possession of the pledgee. He is entitled to retain possession and under certain circumstances to sell for the satisfaction of his claim.

The other type is that which depends upon title, and there are two common, well recognized forms of that kind of security. The first is called a conditional sale, where a contract is made by which A undertakes to sell something to B but it is agreed that the title shall not vest in B, even though the possession may pass to B, until B has paid for it. That is briefly the type of security known as conditional sale and it is in common use.



The other form is that of mortgage. Of course we are talking here about security in personal property. When you come to talk about security in real estate, mortgage needs some further amplification or discussion, because here in New York at least there has been developed what they call the lien theory. Historically, a mortgage always, whether of real estate or personalty, involved the putting of title into the mortgagee or person to be secured. That is still true in the case of personalty, but here in New York it is not true in the case of realty. In the case of realty a mortgage here in New York does not convey title to the mortgagee; it gives him what the law recognizes and enforces as a lien, title remaining however in the mortgagor. That is rather anomalous, and I think to some extent an unsound legal doctrine, but it is the law here in New York.

We have then these three general types of security —pledge, conditional sale, and mortgage.

Now whenever a question of trust receipts was presented to a lawyer he immediately tried to analyze the type of security and to see what particular classification it fell under. The trust receipt obviously was not a pledge. It didn't seem to be a mortgage, it didn't seem to be a conditional sale, and that to lawyers, was the chief reason why the subject presented serious difficulties.

In some respects it is obviously like a mortgage,

but as almost everybody knows a chattel mortgage is not of much value in this country unless it is recorded and as banks and lawyers know, the trust receipt if it is good at all is good without recording. Therefore, it does not exactly resemble a mortgage.

As a matter of fact, the trust receipt is an anomaly in the law. I may call it a by-product. It does not rest upon any statute for its validity. Nevertheless, it is the result of the enactment of statutes, namely the recording acts. If there were no recording acts relating to chattel mortgages there would never have been any occasion or reason for the development of trust receipts. Because there were recording acts which were, in this particular field at least, undesirable, the law through a process of evolution developed this anomalous type of security which we know as trust receipts.

Now I don't suppose it is necessary to describe in any detail the appearance or wording of a trust receipt. Commonly they are used in connection with import transactions. The importer goes to a banker, gets a letter of credit in favor of the shipper on the other side, who is the seller or the seller's agent, and which provides that upon presentation of bills of lading and proper documents the bank will accept and pay the drafts drawn in connection with his contract. Those documents, of course, are taken in the name of the bank and when the goods come forward, the



documents, which are documents of title and for all legal purposes are the goods, are turned over to the importer under a trust receipt. You may have the simple form where the documents are turned over against a trust receipt to allow the importer to enter the goods and to warehouse them, and immediately deliver to the bank the warehouse receipts issued in its name. That is a limited form not uncommonly used.

It may be followed by another larger form which will permit the importer to make a sale which he has arranged to a buyer, John Smith. It may name the buyer and also provide that the money shall immediately be paid over to the bank. Or a still wider form of trust receipt may be used which permits the importer to sell as he can or to manufacture or fabricate in one way or another and to sell the goods. These all provide that the title is to remain in the bank.

This is obviously a security transaction and it is probably worth a moment's time to point out its differences from the other well recognized forms of security. It obviously is not a pledge because the essence of pledge is not title but possession, and if the property were pledged to the bank that pledge, and therefore the security, would be lost immediately possession was turned over to the importer.

It likewise is not a conditional sale in spite of the

fact that the courts of Connecticut have decided and one or two other courts have talked as if they thought it was a conditional sale.

The reason it isn't a conditional sale is this: in a conditional sale the seller is the man who has goods to sell and he is interested in selling the goods as a seller of goods and interested in getting the purchase price of goods, and the only contract which exists between him and the buyer is a contract for the purchase of goods. Now in the trust receipt case the seller was the man in China or in Brazil or somewhere else (and I might say in passing that I am simply taking that class of case because it is perhaps a little simpler to follow. There is no reason why a transaction shouldn't be a domestic one just as well as a foreign one). The seller is out of the picture when he turns over the documents to the bank or its correspondent and gets his money on his draft. He is through. That is the only contract of sale that ever has existed. The contract between the bank and the importer is not a contract for the sale of goods and the payment of the purchase price because the bank has its goods to sell; it isn't in the business of selling goods; it is in the business of lending money. The contract between the bank and the importer is a contract of loan. If it were a conditional sale the whole contract would be over and the liability of the purchaser would be at an end if the seller retook



the goods. But if the bank retakes the goods under the trust receipt the importer is still under the same liability he was under in the first place. His contract with the bank is not to pay the purchase price of goods but to repay a loan or an advance made at his request and for his benefit. The subject matter about which the bank and the importer are dealing at all times is a lending of money and a repayment of money, and not the purchase and sale of goods, because if those goods in the hands of the bank, for example, were destroyed and there was no insurance, the importer would be equally liable to the bank, as he was at the inception of the transaction; whereas if it were a conditional sale and the goods were destroyed while in the hands of the seller, of course the buyer would be under no obligation whatever.

The essential differences between those two classes of transactions must be quite apparent, although as I say in a number of decisions and in two or three states they have caused confusion in the minds of the courts.

Now there remains only one other kind of security, and that is mortgage. The ordinary mortgage—and we are talking of chattel mortgage—consists of a conveyance of the title by the title holder or mortgagor to another as security for an advance or loan made by the other party to or for the benefit of the mortgagor. If the mortgagor, for example, gives a

mortgage on an automobile, he may in addition also deliver possession to the mortgagee. The mortgagee is not then a pledgee although he looks like one, but he is a mortgagee in possession. If that is done of course there is no necessity for recording the mortgage because nobody is deceived by the situation. The mortgagee is in possession of his security and therefore the creditors of the mortgagor are not liable to be deceived. But if the mortgagor, the owner of the car, wants to keep the machine and to continue to use it, he may still by a proper instrument convey title to the mortgagee. In such a case practically every state has required that the instrument be recorded so that the world may, theoretically at least, have notice of the fact that the man who previously owned the car, and who now apparently owns it and uses it, is not the real owner, but that someone else is the real owner and has a claim on it as security.

The purpose of those statutes is of course to prevent a false credit being given to people on whom the mortgagor might impose through his apparent ownership of the car.

That is, as I say, the classic, normal form of chattel mortgage. It requires recording if possession is to remain in the mortgagor. The trust receipt, however, does not require recording in order to be valid. Nevertheless, possession is not in the hands



of the title owner, the bank, but is in the hands of someone else.

The question is, what is the true nature of a trust receipt, and I want to point out that the trust receipt is really a chattel mortgage, but of a peculiar and exceptional kind. There are certain facts in connection with the trust receipt situation which enable us to distinguish it from the normal mortgage situation and which justify, in the opinion of businessmen, and so far at least in the opinion of legislators, the exclusion of trust receipts from the recording statutes.

As I said, the essence of a mortgage consists of title in the person secured while possession may be in the borrower. Where the borrower has previously owned the property and has conveyed it to the mortgagee, himself retaining possession, you have the ordinary type of chattel mortgage which requires recording. It isn't necessary however, that title should have been conveyed to the lender by the borrower, and that is the fact which affords a line of cleavage between the trust receipt form of security and the ordinary chattel mortgage form, because in the trust receipt situation we have first a seller in whom the title originates. That person is not seeking credit, he is merely a seller and he is to get cash for his goods. The lender is the bank, the second party. The third party is the importer, who has never up to

that time owned the goods, but for whose benefit nevertheless the entire transaction is undertaken.

Now inasmuch as the importer has never previously owned those goods and has never had them in his possession, no one who has any knowledge of business affairs can be deceived by the fact that he suddenly comes into possession of them.

The transaction, as I have tried to make clear is, in legal theory, a chattel mortgage but it has distinguishing marks which differentiate it from the ordinary chattel mortgage in that the title comes to the bank from a third party rather than from the mortgagor, whereas in the ordinary mortgage the title comes from the owner who gets the credit and who retains possession of the goods.

The trust receipt is useful and may properly be employed only in the circumstances that I have described. If it is used in the normal chattel mortgage situation it is of no more value than an unrecorded chattel mortgage would be. Now I am not prepared to say that in some circumstances an unrecorded chattel mortgage may not have value, but no one ought to deceive himself into thinking that he is getting more security than he really is getting. If you clearly realize that you are doing an unrecorded chattel mortgage business and if you clearly recognize the limits of the security that you are obtaining, it is all right to go ahead and do it, whether you do



it under what is frankly a chattel mortgage or whether you do it under the guise of a trust receipt.

The difficulty is this: that the trust receipt has frequently been used in circumstances when it did not have validity beyond that of an unrecorded chattel mortgage, but where the users have deceived themselves in thinking that they had a good trust receipt. The most important point I want to make in what I have to say is to point out that there is only one set of circumstances in which a trust receipt can properly be used. If it is used in any other case it is not good as a trust receipt and the doctrines of trust receipt do not apply. Unless you have that three-cornered transaction of a seller and a lender and a borrower your trust receipt is not good. If a man comes to the bank and says, "Here are some warehouse receipts for cotton that I own. I want to pledge them to you," you may by taking the warehouse receipts get a good security, but if he then comes and says, "Hand me back my warehouse receipts and I will take them under trust receipt," don't deceive yourself into thinking that you have any security left after you have turned the warehouse receipts back to him. You have practically nothing except his unsecured obligation to pay.

The trust receipt cannot be properly used under those circumstances and it doesn't do any good to label the document that you use "trust receipt" be-

cause the court that is going to examine the transaction isn't going to be guided in reaching its conclusion by the fact that the document may have "trust receipt" written across the top any more than it is going to be guided by the fact that it may have "chattel mortgage" written across the top, because the court will look at the substance of the transaction and not at any labels.

The difficulty which has arisen in the minds of lawyers and which has also existed in the minds and in the practice of bankers, in many, many cases—I think in practically all cases—has been due to a failure to recognize the limits of the proper trust receipt doctrine; has been due to a failure to realize that the trust receipt can be used only in the one class of cases that I have described. It has been due to the fact that the trust receipt has been used in the other class that I have also described where it hasn't any business to be used. The distinction, if I have succeeded in making it plain, is the backbone, the essence of the trust receipt doctrine.

To go a little farther into some of details of the doctrine, I said that an ordinary chattel mortgage requires recording, whereas a trust receipt is valid without recording. There are at least two states in the country where the recording statutes are so drawn that even a trust receipt is not valid unless it is recorded. Those states are Ohio and Illinois, and



consequently you should never use a trust receipt in either of those states with the idea that you are safe unless you record it.

It is not necessary or useful here to go into the history of the development of the trust receipt doctrine. That is primarily of interest to lawyers. It is an interesting history because it is an evolution of new principle for which there was demand because of the recording statutes. I may remark that the classic example of trust receipt that is usually talked about is the import case, such as an importation of coffee or silk or some other foreign commodity. The doctrine of trust receipts however did not arise from import transactions. The cases which laid the foundation of this doctrine were all cases relating to domestic transactions. They were in every case, letter of credit cases, but they were all domestic transactions.

There have been, during the last ten or twelve years a number of litigations, especially affecting automobile financing operations, where the argument has been made that the trust receipt doctrine applies only to import transactions and the courts have been urged, indeed they have sometimes been told, that domestic transactions of the same kind did not permit the use of the trust receipt. There is nothing in the argument. In proper cases a trust receipt can be

used in domestic transactions just as well as it can in foreign cases.

The doctrine is just as vigorous and is better established than it ever has been. In examining practically all the cases that had been decided on the subject a few years ago, I found an extraordinary consistency in the opinions. They differed in respect to the nomenclature which they used. Some of them as I said called the arrangement "conditional sale." In Pennsylvania they called it a "bailment," and in other places they said, "We will not attempt to define the exact nature of this security." But they all, practically without exception, upheld the principle of the trust receipt and enforced it. Consequently when one came to assemble all of the decisions and from the opinions to evolve a statement of the doctrine of trust receipts, one did not have to do what one has to do in many other branches of the law, either distinguish or explain away the inconsistent rulings, because the decisions of the courts in this field have been extraordinarily consistent.

There are two or three statutes which have a bearing upon this subject to which I want to refer. One is what is known as the Factors' Act which is of particular importance here in New York. The Factors' Act was taken from an English statute which was passed many years ago but it has only been adopted by New York and Massachusetts. In the



absence of the Factors' Act it is a principle of the common law that an agent to sell, that is, an agent whose power extends to the sale of your goods, cannot make a legal or binding pledge, because a pledge would be beyond the scope of his authority. That is, as I say, common law in the absence of statute. But in England, in New York, and in Massachusetts, a statute has been passed known as the Factors' Act which says in effect that a person who is entrusted with the possession of goods with power to sell can make a valid pledge of those goods. That means in respect to trust receipts that if a bank delivers possession of goods to the importer with power to sell, but without explicit power to pledge, the importer can nevertheless take those goods or the warehouse receipts, or bills of lading, to some other bank and make a valid pledge, and if the other bank retains possession of the goods or the documents it will prevail over the first bank which merely holds the trust receipt.

That is a risk which every bank in New York takes when it delivers goods under trust receipt. It is taking a risk that its customer may repledge the goods with someone else for a present advance.

Another act which is one of the uniform acts and which has been widely adopted is the Bills of Lading Act. It accomplishes practically the same result which the Factors' Act accomplished but it is limited

in its effect to bills of lading. However, it goes a little farther than the Factors' Act in that a repledge under the Factors' Act must be for a present consideration. The Bills of Lading Act includes within its definition of value an antecedent obligation. In other words, if your importer takes the bill of lading, which he has obtained under trust receipt, to another bank and pledges it as security for a debt which he already owes to that bank, the pledge is good.

Another statute which I want to mention is the Warehouse Receipts Act, and that accomplishes with respect to warehouse receipts practically the same thing which the Bills of Lading Act accomplishes with respect to bills of lading. Its definition of value is the same. In other words, a pledge of a warehouse receipt for a pre-existing obligation is good even though the pledgor has secured possession of the warehouse receipt by giving a trust receipt.

The curious result of these two statutes, the Bills of Lading Act and the Warehouse Receipts Act is this: that the importer or the customer can do with these documents of title which merely represents the goods, what he could not do with the goods themselves. If he had a bale of cotton he could not make a valid pledge of that cotton for an antecedent or pre-existing obligation, but if he has a bill of lading or warehouse receipt which represents that cotton he can make such a valid pledge. In other words, you



are taking a slightly broader risk when you turn over bills of lading or warehouse receipts to your customer than you are when you turn over the goods themselves. As you generally deal with documents of title I want to point that fact out to you.

Not infrequently a bill of lading is turned over to a customer to warehouse the goods or to sell to a particular customer. If there is any likelihood that the customer will place the goods in warehouse you should do one of two things: you should either see to it that he turns over the warehouse receipts to you as soon as he gets them or you should very carefully stipulate in the document that he cannot take a negotiable warehouse receipt to his own order. If he takes a negotiable receipt to his own order and does not immediately turn it over to you, you are running a risk that he may dispose of it somewhere else.

I have outlined rather sketchily the fundamental principles of the law of trust receipts. As a practical proposition you all know that the most difficult problem is often to put your hands on the goods. If you decide that it is time to protect yourself by recapture, or if your customer becomes bankrupt and you have to recover the goods, you are often faced with a problem of identifying them. That is under many circumstances an almost impossible task and I do not know of any way in which it can be simplified unless you go to the trouble of watching the goods closely

and tracing them as they progress on their line through the process of manufacture.

You can with the aid of the court recapture your goods provided you can identify them. But it is obvious that they may have become mixed with goods of other people; they may have become mixed with goods which are indistinguishable. They may have been changed by the addition of labor; they may have been changed by the addition not only of labor but of other materials, by weaving or any of the other processes of manufacture. They may have been changed in appearance by dyeing and all kinds of things which may happen, and it may be that you will find your goods involved with other goods which have been released to the customer under trust receipts held by two or three other banks. You can picture the most complicated situations that may result from the fact that the customer has gone on with the preparation of the goods for sale.

You can suggest many particular cases which may arise. In some cases it is absolutely impossible to do anything about it. The goods are gone; you can't find them; you can't identify them, and that is the end of it. There are cases where you can trace the goods into their proceeds. If the goods have been sold and the purchase price has not been collected you can collect it. If the purchase price has been collected and can be identified you can get it. If it has



been mingled in the general bank account of the customer and has not been drawn out since it was put in, you can generally get it. But it may happen that it has just disappeared.

There are a good many cases which you can picture to yourself where if you asked me or any other lawyer what your rights are, we would be obliged to say we do not know because under a good many circumstances the courts have never decided what the rights of the parties are. I have tried to picture a good many such situations and I must say that in some of them I have no recourse except to figure out what I think the law ought to be without being able to point to what the law is.

I think perhaps I can crystallize what I have had to say better by reading to you, if you will bear with me, certain conclusions that I came to some time ago in connection with trust receipts, and which really sum up the matter. These were formulated about eight years ago and so far as I know they are as sound now as they were when they were formulated.

The first one is, "The only situation in which a trust receipt may properly be used is one in which the title of property by way of security is conveyed to the creditor by an owner who is not the person responsible for the satisfaction of the obligation which the property secures but where such obligor

has a contractual or beneficial interest in the property subject to the satisfaction of such obligation."

In practice, the trust receipt situation exists only in connection with advances for the purchase of goods by way of the payment of drafts against bill of lading.

"(2) The trust receipt should never be used in connection with the redelivery of property pledged or mortgaged by the person signing the trust receipt.

"(3) In the proper trust receipt situation, the creditor, generally a bank or banker, has legal title to the property for the purpose of security. This creditor is a mortgagee and the arrangement is a chattel mortgage, but of a peculiar type, distinguishable from the usual chattel mortgage by reason of the fact that the obligor has not prior to the arrangement had either title to or possession of the property mortgaged.

"(4) Except in Ohio, Illinois, and perhaps South Carolina and Virginia, cases so far decided hold that the trust receipt does not come within the provisions of the recording acts respecting chattel mortgages or conditional sales.

"(5) In New York and Massachusetts, where the Factors' Act is in force, a bona fide mortgagee or pledgee for present value obtains from the signer of the trust receipt a right superior to the title of the creditor who holds the trust receipt.



"(6) The adoption of the Uniform Bills of Lading Act and the Warehouse Receipts Act by various states has given to those instruments in large degree the qualities of negotiable instruments. These laws accomplish the results of the Factors' Act. In those states which have adopted the definition of 'value' as recommended by the Committee on Uniform Legislation, an antecedent debt constitutes value, and a bona fide purchaser, pledgee or mortgagee of such a document, regular on its face and from one to whom it has been entrusted by the holder of the trust receipt, obtains a title superior to the rights of the holder of the trust receipt.

"(7) If the goods themselves are entrusted under trust receipt, appropriate language should be used to negative any presumption of right in the signer to take negotiable warehouse receipts to his own order.

"(8) Except as noted in (4), property delivered to the signer of a trust receipt under circumstances suitable for the use of such an instrument may, if identified, be retaken from the signer at any time before the satisfaction of the obligation secured by the property. It may also be retaken from his receiver, assignee, trustee in bankruptcy or an attaching creditor. Its proceeds may likewise be retaken, provided they can be identified.

"(9) The unpaid purchase price of property delivered to the signer against his trust receipt and by

him sold to a bona fide purchaser may be recovered by the holder of the trust receipt directly from such buyer.

"(10) The property delivered in a proper case against trust receipt may be recovered by the holder of the trust receipt, prior to payment of the obligation secured thereby, from any person to whom the signer has delivered the same, unless such right of recovery is cut off by the exercise of a power of sale, express or implied, or statutory provisions which include a bona fide pledge or mortgage within the scope of such power.

"(11) The trust receipt cannot assure to the holder thereof any rights beyond those which he would have had as the holder of an unrecorded chattel mortgage, an equitable pledge or mortgage, or a simple contract, if it is used in any case other than that which has been defined as a proper trust receipt case.

"(12) The benefit of the trust receipt doctrine is not dependent upon any special virtue in the name or the precise form or appearance of the agreement. If the agreement can in substance be shown to have been clearly made between the parties in a proper case, the legal results will follow, even though resort is had to the original credit agreement for the purpose of establishing the existence of the security arrangement."

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